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FIA

February 4, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: CME Revised Petition to Commingle Customer Funds Used to Margin Credit Default Swaps with Other Funds Held in Segregated Accounts

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the Chicago Mercantile Exchange's ("CME's") revised petition for an order pursuant to section 4d(a)(2) of the Commodity Exchange Act ("Act"). The requested order would authorize the CME and FCMs clearing through the CME to commingle customer funds used to margin cleared credit default swaps ("CDS") with other funds held in customer segregated accounts maintained in accordance with section 4d(a)(2) of the Act and Commission rules ("section 4d order"). For the reasons set forth below, FIA does not believe that collateral deposited to margin cleared CDS should be permitted, at this time, to be commingled with the customer segregated funds account.

In our September 14, 2009 letter to the Commission commenting on the CME's initial petition, we noted that cleared CDS do not appear to meet any of the factors that we had identified as potentially supporting a finding that cleared-only over-the-counter ("OTC") derivatives and related margin should be permitted to be held in a customer segregated account.[2] In particular, because cleared CDS may not be easily offset or hedged, the risk to

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[1] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest futures commission merchants ("FCMs") in the United States. Among FIA's associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[2] Specifically, (i) the OTC contract is integrally related with an exchange-traded contract; (ii) the OTC contract is sufficiently liquid to permit offset in the event of a clearing member default; (iii) in the absence of offset, the risk of carrying the positions may be easily hedged; and (iv) the cleared-only OTC contracts provide opportunities for cross-margining with exchange-traded contracts. Letter from John M. Damgard, President,

the customer segregated account in the event of a default is especially difficult to assess. Therefore, we recommended that action on the CME petition be deferred until the Commission had adopted objective standards by which the Commission will determine which cleared OTC derivatives will be eligible or required to be held in a section 4d segregated account and which cleared OTC derivatives will be required to be held in separate, *i.e.*, non-section 4d, accounts.[3]

The significant new fact underlying the CME's revised petition is the change in its rules relating to the structure and operation of the guaranty fund. In particular, the CME amended Rule 802, Protection of the Clearing House, and Rule 816, Guaranty Fund Deposits, to provide that a clearing member's guaranty deposit will be allocated to specific tranches based in substantial part on the product class(es) cleared by the member firm. As the CME explains in the revised petition, the purpose of the amendments is to ensure a commensurate assumption of risk by those firms clearing each product class.[4]

Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated September 14, 2009, "Chicago Mercantile Exchange Petition to Commingle Customer Funds Used to Margin Credit Default Swaps with Other Funds Held in Segregated Accounts," a copy of which is enclosed as Exhibit A.

[3] As the Commission will recall, comments on the CME's initial petition for a section 4d order were required to be filed concurrently with comments on the Commission's proposal to amend Commission Rule 190.01(a) to add a sixth and separate account class for a limited group of cleared OTC derivatives. In supporting the proposed amendment, we also recommended that, concurrent with the creation of the proposed separate account class for cleared OTC derivatives, the Commission adopt (after notice in the Federal Register and a reasonable opportunity for comment) objective standards by which the Commission will determine which cleared OTC derivatives will be eligible or required to be held in a section 4d segregated account. We expressed our concern that failure to adopt such objective standards will result in legal uncertainty in the event of an FCM bankruptcy, which may threaten the integrity of the section 4d customer segregated account. Moreover, a combined account could delay or prevent the transfer of exchange-traded positions to a solvent FCM. Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated September 14, 2009, "Separate Account Class for Cleared Only Derivatives," a copy of which is enclosed as Exhibit B.

[4] The CME self-certified these rule amendments in accordance with the provisions of Commission Rule 40.6 by a filing with the Commission dated December 11, 2009. The CME assigns the products it clears to one of three classes: (1) the CDS Product Class; (2) the Base Product Class, *i.e.*, all products that are not assigned to the CDS Product Class or the Alternate Product Class; and (3) the Alternate Product Class, *i.e.*, any product approved by the Clearing House Risk Committee.[4] A clearing member's required guaranty fund deposit is determined, in part, on the volume of business that the clearing member conducts in each product class.

The guaranty fund is divided into four tranches: (1) the Base Product tranche is equal to 80 percent of the guaranty fund amounts contributed with respect to the Base Product Class; (2) the CDS tranche is equal to 80 percent of the guaranty fund amounts contributed with respect to the CDS Product Class; (3) the Alternate tranche is equal to 80 percent of the guaranty fund amounts contributed with respect to the Alternate Product Class; and (4) the Commingled tranche is equal to the remaining 20 percent of the guaranty funds contributed with respect to all of the foregoing product classes. A clearing member's guaranty fund deposit is allocated to each product class tranche based on the proportion of its business that it transacts in each product class. Thus, for example, the guaranty fund deposit of a clearing member that clears only CDS would be allocated only to the CDS tranche and the Commingled tranche. Similarly, the guaranty fund deposit of a clearing member that clears only exchange-traded futures would be allocated only to the Base Product tranche and the Commingled tranche.

The amended rules are intended to provide a level of protection to the guaranty fund deposits of clearing members that do not clear the product that caused the default. This protection is not complete, however. If the loss incurred by a defaulting clearing member is large enough, not only would the guaranty funds deposited by clearing members that clear only CDS be applied to compensate the clearing house for losses caused by a CDS clearing member, but a portion of the guaranty funds deposited by clearing members that clear only exchange-traded futures could be applied to compensate the clearing house for losses caused by a CDS clearing member.[5]

FIA is not taking a position with respect to the substance of the CME's amended rules. Certain FIA member firms support the rules; others do not. Nonetheless, we are agreed that the amendments do not address the concerns we raised in our September 14 letter and reiterate here, *e.g.*, in the event of an FCM default, (i) the risk of legal uncertainty may threaten the integrity of the section 4d customer segregated account or, (ii) a combined account may delay or prevent the transfer of exchange-traded positions to a solvent FCM. Consequently, our view that action on the CME petition should be deferred is unchanged.

Although FIA is not taking a position on the substance of the amended rules, we want to take this opportunity to express our concerns regarding the process by which the amendments to CME Rules 802 and 816 were adopted and certified to the Commission. FIA has consistently taken the position that the procedures by which a designated contract market or derivatives clearing organization adopts and enforces its rules should be transparent and should assure that all members and other affected market participants have an opportunity to express their views and otherwise participate in the process. This is especially true when such rules directly affect the financial obligations of clearing members or relate to the financial integrity of the derivatives clearing organization.

In 2004, in response to the Commission's request for comments on the governance of self-regulatory organizations ("SROs"),[6] FIA devoted considerable time discussing the need for greater transparency in SRO rulemaking.[7] Acknowledging that neither the Act nor the Commission's rules prescribe the procedures that an SRO should follow in adopting rules, we nonetheless asserted that an SRO cannot comply with the provisions Commission Part 40, unless the SRO's rulemaking procedures are designed to solicit input from all members and

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[5] In the event of a clearing member default, the CME will first apply the assets of the defaulting clearing member available to the CME (*i.e.*, the defaulting member's guaranty fund deposit, performance bond deposits, memberships and Class A shares), followed by the CME's own surplus funds (approximately $100 million) to reimburse the CME for the loss incurred. If the loss exceeds these sums, the CME will then determine the product class responsible for the loss. If the loss was caused by CDS, the CME would then apply the guaranty fund allocated to the CDS tranche, then the Commingled tranche and, if necessary, the Base Product tranche.

[6] 69 Fed.Reg. 32326 (June 9, 2004).

[7] Letter from John M. Damgard, President, Futures Industry Association, to Jean A. Webb, Secretary to the Commission, dated September 30, 2004, a copy of which is enclosed as Exhibit C.

affected market participants on significant rule proposals.[8] More recently, FIA took a more definitive position, recommending that some public process, including a 30 day notice and comment period, should be afforded to all interested parties before SRO rules are imposed on market participants.[9]

We understand that, prior to adopting the amendments to Chapter 8, the CME consulted a number clearing members. However, the CME took no steps to afford all clearing members and other affected participants an opportunity to analyze or express their views on this fundamental change in the structure of the guaranty fund. Consequently, many CME members (and market participants) were not aware of the amendments until they were self-certified with the Commission.

We respectfully submit that such a result is unacceptable. To reiterate, SRO procedures must afford all members and other affected market participants an opportunity to express their views and otherwise participate in the rulemaking process, especially when such rules directly affect the financial obligations of clearing members or relate to the financial integrity of the derivatives clearing organization. If an SRO is unwilling to adopt and implement transparent rulemaking procedures voluntarily, including requesting Commission approval of SRO rules in appropriate circumstances, we urge the Commission to takes such steps as its deems necessary to ensure this result.[10]

Conclusion

FIA appreciates the opportunity to submit these comments. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

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[8] Further, to the extent affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, they must have the opportunity to seek redress with the Commission.

[9] Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, and Elizabeth M. Murphy, Secretary to the Securities and Exchange Commission, dated September 14, 2009, "Submission for the Record on Harmonization," a copy of which is enclosed as Exhibit D.

[10] To this end, the Commission has the authority under section 5c(c) of the Act to adopt interpretative guidance with respect to SRO rulemaking procedures. In addition, FIA supports the provisions of HR 4173, which would specifically authorize the Commission, in prescribed circumstances, to delay approval of self-certified rules, pending Commission review, including publication of the rule for a 30-day comment period.

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner
Honorable Scott O'Malia, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
Robert B. Wasserman, Associate Director

EXHIBIT A

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FIA

September 14, 2009

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: Chicago Mercantile Exchange Petition to Commingle Customer Funds Used to Margin Credit Default Swaps with Other Funds Held in Segregated Accounts

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] submits this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the Chicago Mercantile Exchange's ("CME's") petition asking the Commission to issue an order pursuant to section 4d(a)(2) of the Commodity Exchange Act ("Act") authorizing the CME and futures commission merchants clearing through the CME to commingle customer funds used to margin credit default swaps ("CDS") with other funds held in customer segregated accounts maintained in accordance with section 4d(a)(2) of the Act and Commission rules.

FIA supports the efforts of the CME and other clearing organizations to develop and provide clearing services for over-the-counter ("OTC") derivatives, including CDS. Establishing a proper clearing mechanism for standardized OTC derivatives is a critical element of the several regulatory reform proposals that have been submitted by the Obama Administration, members of Congress and the Commission to reduce systemic risk in the financial system. The CME is to be congratulated for taking on this task.

FIA also recognizes the many benefits that may flow from combining cleared customer CDS positions, and the funds deposited to margin such positions, with the customer segregated account maintained in accordance with section 4d(a)(2) of the Act. Customers take special comfort in knowing that their funds are held in segregation and that, in the event of an FCM default, the Bankruptcy Code and the Commission's bankruptcy rules, 17 CFR Part 190, assure futures customers a priority over general creditors. A combined account could also facilitate the cross-margining of positions, permitting the more efficient use of capital.

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However, we also appreciate that commingling exchange-traded futures and cleared OTC derivatives may pose potential risks to the customer segregated account. Cleared OTC derivatives may dilute the pool of assets available to exchange-traded futures customers in the event of an FCM bankruptcy. Further, a combined account could delay or prevent the transfer of exchange-traded positions to a solvent FCM. Because of these risks, FIA does not believe that all cleared OTC derivatives should be permitted to be commingled with the customer segregated funds account.

The Commission appears to share our concerns. In a Federal Register release dated August 13, 2009, the Commission has proposed to amend the Commission's bankruptcy rules to establish a sixth and separate account class for a limited group of "cleared OTC derivatives."[2] This separate account class would seek to provide customers with "cleared OTC derivatives" positions a priority over general creditors without affecting the pool of assets held in the "futures" account, *i.e.*, assets held in accordance with section 4d(2)(a) of the Act and related Commission rules.

By separate letter dated September 14, 2009, FIA commented on the Commission's proposal.[3] In that letter, we supported in concept the Commission's proposal to create a separate account class for "cleared OTC derivatives," while urging the Commission to adopt concurrently with the amendment objective standards by which the Commission will determine which cleared OTC derivatives will be eligible or required to be held in a customer segregated account and which cleared OTC derivatives will be required to be held in separate, *i.e.*, non-section 4d, accounts. We expressed our concern that failure to adopt such objective standards will result in legal uncertainty in the event of an FCM bankruptcy, which may threaten the integrity of the customer segregated account.

In that letter, we also set out, for purposes of discussion only and subject to further consideration, our initial thoughts on the factors that we believe would support a finding that cleared-only OTC derivatives and related margin should be permitted to be held in a customer segregated account: (i) the OTC contract is integrally related with an exchange-traded contract; (ii) the OTC contract is sufficiently liquid to permit offset in the event of a clearing member default; (iii) in the absence of offset, the risk of carrying the positions may be easily hedged; and (iv) the cleared-only OTC contracts provide opportunities for cross-margining with exchange-traded contracts.[4]

We are not convinced that the CDS contracts the CME intends to clear meet any of these standards. Therefore, we cannot support the CME's petition and recommend that action on the petition be deferred. In particular, we are concerned that such contracts may not be easily

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2 74 Fed.Reg. 40794 (August 13, 2009).

3 Letter from John M. Damgard, President, Futures Industry Association, to David A. Stawick, Secretary to the Commission, dated September 14, 2009.

4 *Id.*, p. 4, fn. 11.

offset or hedged. Therefore, we are unable to assess the potential risk to the customer segregated account in the event of a default. Further, CDS are not integrally related to exchange-traded futures contracts and do not appear to provide any opportunity for cross margining.[5]

We appreciate the opportunity to submit these comments. If the Commission has any questions concerning the matters discussed in this letter, please contact Barbara Wierzynski, FIA's Executive Vice President and General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner

Division of Clearing and Intermediary Oversight
Ananda Radhakrishnan, Director
Robert B. Wasserman, Associate Director

[5] In contrast, standardized cleared OTC derivatives involving interest rates or currencies may well meet the standards set out above, *i.e.*, they would be integrally related to exchange-traded futures, sufficiently liquid to permit offset or hedge, and provide opportunities for cross margining. In these circumstances, commingling such positions, and related margin, with the customer segregated account may be appropriate.

EXHIBIT B

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September 14, 2009

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington DC 20581

Re: Separate Account Class for Cleared Only Derivatives
74 Fed.Reg. 40794 (August 13, 2009)

Dear Mr. Stawick:

The Futures Industry Association ("FIA")[1] welcomes the opportunity to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's) proposal to amend its bankruptcy rules, 17 CFR Part 190 ("Bankruptcy Rules"). The proposed amendments would achieve two purposes.

Futures Account Class. First, the amendments would codify the Commission's September 2008 *Interpretative Statement Regarding Funds Relating to Cleared-Only Contracts Determined to be Included in a Customer's Net Equity* ("Interpretative Statement").[2] In that Interpretative Statement, the Commission concluded that where, pursuant to Commission order, cleared-only contracts,[3] and property margining such contracts, are properly included in an account segregated in accordance with section 4d of the Commodity Exchange Act ("Act"), a claim arising out of a cleared-only contract, or property margining such a contract, would be includable in the futures account class.[4]

In support of this determination, the Commission cited its October 2004 order, in which it held that contracts traded on non-domestic boards of trade, and the assets margining such

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2 73 Fed.Reg. 65514 (November 4, 2008).

3 A cleared-only contract is a derivatives contract that is cleared by a registered derivatives clearing organization ("DCO") but not executed on or subject to the rules of a designated contract market ("DCM").

4 The Bankruptcy Rules currently list five account classes that must be recognized as separate account classes by a trustee: (i) futures (*i.e.*, contracts executed on a DCM) accounts; (ii) foreign futures accounts; (iii) commodity options accounts; (iv) leverage accounts; and (v) delivery accounts. 17 CFR §190.01(a).

contracts, that are included in accounts segregated in accordance with section 4d of the Act, should be included in the futures account class.[5] As the Commission noted then:

> [I]t would be inconsistent with the Commission's intentions to deny customers who had contributed property that was, in accordance with Commission Orders, deposited into accounts segregated pursuant to Commission Regulation 1.20, any participation in those accounts based on those contributions. . . . [C]ustomers whose assets are deposited in such an account should benefit from that pool of assets.[6]

To codify the Interpretative Statement, therefore, the Commission has proposed to revise Rule 190.01(a) to add the following *proviso*:

> *Provided, further*, that, if positions in commodity contracts of one account class (and the money, securities, and/or other property margining, guaranteeing, or securing such positions), are, pursuant to a Commission order, commingled with positions in commodity contracts of the futures account class (and the money, securities, and/or other property margining, guaranteeing, or securing such positions), then the former positions (and the relevant money, securities, and/or other property) shall be treated, for purposes of this part, as being held in an account of the futures account class.

Cleared OTC Derivatives Account Class. Second, the Commission proposes to amend Commission Rule 190.01(a) to add a sixth and separate account class for a limited group of cleared over-the-counter ("OTC") derivatives. As defined in proposed Rule 190.01(oo), "cleared OTC derivatives", including the money, securities and other property held to margin such positions, that would be included in this account class would be limited to those cleared OTC derivatives and related assets that are:

- carried by an FCM;
- cleared by a DCO;
- with respect to which the Commission has not issued an order requiring such positions and assets to be held in a section 4d account; *but*

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5 69 Fed.Reg. 69510 (November 30, 2004).

6 69 Fed.Reg. 69510, 69511 (November 30, 2004).

- with respect to which such positions and assets are nonetheless "required to be segregated in accordance with a rule, regulation or order issued by the Commission,[7] or which are required to be held in a separate account for cleared OTC derivatives only, in accordance with the rules or bylaws of a [DCO]."

Discussion. FIA supports the proposed amendment to Commission Rule 190.01(a) that would confirm that a claim arising out of a cleared-only contract, or property margining such a contract, would be includable in the futures account class when such cleared-only contracts, and property margining such contracts, are properly included in an account segregated in accordance with section 4d of the Act. It is appropriate that the Commission's guidance to trustees in connection with the bankruptcy of a commodity broker be found in the Commission's Bankruptcy Rules rather than one or more interpretative statements issued from time-to-time.

In addition, we support in concept the Commission's proposal to create a separate account class for "cleared OTC derivatives." We agree that customers that participate in cleared OTC derivatives should have the benefits of a separate account and customer priority under the Commission's bankruptcy rules, to the extent that may be provided by law. Further, as is evident from our support of portfolio margining, FIA does not oppose commingling futures segregated positions and funds with related OTC derivatives positions and funds in appropriate circumstances. However, we also believe that certain OTC derivatives positions and funds, even if cleared by a DCO, should not be held in a section 4d account. Therefore, a separate "cleared OTC derivatives" account class, which will provide "cleared OTC derivatives" customers protections comparable to those afforded exchange-traded futures customers, makes eminent sense.

In order to assure that "cleared OTC derivatives" customers receive the benefits intended by the proposed rule, we recommend that, concurrent with the creation of the proposed separate account class for "cleared OTC derivatives", the Commission adopt (after notice in the Federal Register and a reasonable opportunity for comment) objective standards by which the Commission will determine which cleared OTC derivatives will be eligible or required to be held in a section 4d segregated account and which cleared OTC derivatives will be required to be held in separate, *i.e.*, non-section 4d, accounts. We are concerned that failure to adopt such objective standards will result in legal uncertainty in the event of an FCM bankruptcy, which may threaten the integrity of the section 4d customer segregated account.

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[7] The term "segregated" is used in the generic sense. In the Federal Register release accompanying the proposed amendments, the Commission explains:

> "By creating such an account class, the Commission is effectively specifying the manner in which the trustee in the bankruptcy of a commodity broker that is an FCM must treat, in the absence of an applicable Section 4d Order, claims arising out of cleared OTC derivatives when determining net equity and allowed net equity." 74 Fed.Reg. 40794, 40797 (August 13, 2009).

In adopting these standards, the Commission should also provide guidance regarding the treatment of funds deposited to margin "cleared OTC derivatives." In this regard, we ask the Commission to confirm that an FCM's obligations with respect to such funds will be comparable to its obligations with respect to the foreign futures and options secured amount under Commission Rule 30.7. That is, the FCM: (i) will be required to hold such funds in a account separate from the customer segregated account under section 4d(a)(2) of the Act (and, we assume, the foreign futures and foreign options secured amount); (ii) will be entitled to invest such funds in accordance with the guidelines established for the foreign futures and foreign options secured amount; (iii) will be required to obtain acknowledgment letters from depositories holding such funds, similar to those required under Commission Rules 1.20 and 30.7; and (iv) will be required to maintain books and records with respect to such funds.

To date, the Commission's section 4d orders have relied on factors that would appear to be found whenever a DCO would clear an OTC derivatives contract. For example, in issuing its order authorizing ICE Clear US and FCMs clearing through ICE Clear to commingle in a section 4d account funds supporting positions in cleared-only OTC swaps on coffee, sugar and cocoa and other agricultural products,[8] and, again, in authorizing the Chicago Mercantile Exchange ("CME") and FCMs clearing through the CME to commingle in a section 4d account funds supporting positions in cleared-only OTC swaps on corn, wheat and soybeans,[9] the Commission identified the following factors:

- all eligible products are submitted for clearing by a clearing member of the relevant DCO;
- each cleared-only contract is marked to market on a daily basis;
- the DCO applies its margining system and calculates performance bond rates for each cleared-only contract in accordance with its normal and customary practices;
- the DCO applies appropriate risk management procedures with respect to transactions and open interest in the cleared-only contracts;
- the DCO conducts financial surveillance and oversight of clearing members clearing cleared-only contracts sufficient to assure the DCO that the clearing member has appropriate operational capabilities necessary to manage defaults in such contracts; and
- the DCO makes available open interest and settlement price information for cleared-only contracts in the same manner as exchange-traded contracts.[10]

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8 Commission Order dated December 12, 2008.

9 Commission Order dated March 18, 2009, 74 Fed.Reg. 12316 (March 24, 2009).

10 Because the products underlying each of the cleared-only agricultural swaps also underlie exchange contracts traded on each DCO's related DCM, each Commission order was also subject to the conditions that: (i) the related DCM establishes a coordinated market surveillance program that encompasses the cleared-only contracts and corresponding futures contracts listed on the DCM; (ii) the related DCM adopts speculative

The CME suggests similar conditions in its petition requesting an order authorizing the CME and FCMs clearing through the CME to commingle in a section 4d segregated customer funds account assets deposited to margin, guarantee or secure credit default swap ("CDS") contracts cleared by the CME.[11]

As the Commission itself has noted, these factors are essentially identical to the factors that a DCO would apply in clearing exchange-traded contracts. In the November 4, 2008 Interpretative Statement, the Commission found that "over-the-counter contracts that are cleared-only contracts are contracts for the purchase or sale of a commodity for future delivery within the meaning of this section [761] of the Bankruptcy Code. When cleared, they are subject to performance bond requirements, daily variation settlement, the potential for offset, and final settlement procedures that are substantially similar, and often identical, to those applicable to exchange-traded products at the same clearinghouse."[12]

In light of these similarities, it is incumbent on the Commission to enunciate clear, objective standards, pursuant to which affected parties will be able to determine whether particular cleared-only derivatives contracts and related margin will be permitted to be commingled in a section 4d customer segregated account and thereby be included in the futures account class under the Commission's Bankruptcy Rules. The failure to adopt such standards may cause those whose cleared-only derivatives contracts are included instead in the proposed "cleared OTC derivatives" account class to argue in Bankruptcy Court that they should have access to the same pool of assets, *i.e.*, the futures account. At the very least, such a claim threatens to delay the potential transfer of positions from a defaulting FCM to a solvent FCM. More troubling, it could dilute significantly the pool of assets available to meet the claims of exchange-traded futures customers.[13]

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position limits for each cleared-only contracts that are the same as the limits for the corresponding contract listed by the DCM; (iii) the cleared-only contracts are not be treated as fungible with any contract listed for trading on the related DCM; (iv) each FCM acting pursuant to the order keeps the types of records that are described in section 4g of the Act and Commission rules thereunder, including Rule 1.35; and (v) the relevant DCM applies large trader reporting requirements to cleared-only contracts.

[11] Letter from Lisa A. Dunsky, Director and Associate General Counsel, CME, to David A. Stawick, Secretary to the Commission, dated June 15, 2009.

[12] 73 Fed.Reg. 65514, 65515 (November 4, 2008).

[13] We realize that developing these objective standards will not be a simple task and will involve the consideration of a number of potentially competing factors. We encourage the Commission to work with representatives of DCOs, DCMs, FIA and other interested parties in crafting standards that would then be published in the Federal Register for comment. For purposes of discussion only and subject to further consideration, FIA has identified the following factors that we believe would support a finding that cleared-only OTC contracts and related margin should be held in a section 4d account: (i) the OTC contract is integrally related with an exchange-traded contract; (ii) the OTC contract is sufficiently liquid to permit offset in the event of a clearing member default; (iii) in the absence of offset, the risk of carrying the positions may be easily hedged; and (iv) the cleared-only OTC contracts provide opportunities for cross-margining with exchange-traded contracts.

As a consequence of the recent financial crisis, it is likely that DCOs will be asked, or required, to provide clearing services for an increasing number of OTC derivatives.[14] The Commission, in particular, has proposed legislation that, if enacted, would assure this result.[15] In these circumstances, we submit it is essential that the Commission take a more holistic approach to the rules relating to the liquidation of commodity brokers. We suggest that neither the Subchapter IV of Chapter 7 of the Bankruptcy Code nor the Commission's Bankruptcy Rules were written with the understanding or expectation that registered DCOs would clear OTC derivatives.

In this regard, we note that on June 30, 2009, an *ad hoc* group of major buy-side and sell-side OTC derivatives participants submitted a *Report to the Supervisors of the Major OTC Derivatives Dealers on the Proposals of Centralized CDS Clearing Solutions for the Segregation and Portability of Customer CDS Positions and Related Margin* ("Report") to the Supervisors of the Major OTC Derivatives Dealers (as identified in the Report). The Report, which is available on the website of the Federal Reserve Bank of New York,[16] was prepared primarily by Cleary, Gottlieb Steen & Hamilton LLP, counsel to the group ("Cleary"). In Part II.C.2. of the Report (pp. 34-38), Cleary describes the provisions of Subchapter IV of Chapter 7 of the Bankruptcy Code and the Commission's bankruptcy rules, as well as the Commission November 2008 Interpretative Statement.

Cleary concludes that there are reasonable arguments that cleared OTC derivatives may be viewed as "commodity contracts" for purposes of Subchapter IV and Part 190. However, "*the risk of a contrary conclusion is not insignificant.*" [Emphasis supplied.] Cleary adds that "in light of residual uncertainty as to this issue, we believe there is a significant possibility (in a worst-case scenario) that the proposition that cleared [OTC derivatives] contracts constitute "commodity contracts" within the meaning of the Bankruptcy Code may be challenged. . . . In addition, we also believe that any challenge to the proposition that [OTC derivatives] constitute commodity contracts would likely result in significant delay for customers seeking the return of margin through the insolvent FCM."

The Commission may have reached the same conclusion. In its August 17, 2009 recommendations to Congress, the Commission has proposed amendments to the Bankruptcy Code that amend the definition of a "contract market" to remove the reference to "registered entity," which is currently the Commission's basis for finding that cleared-only derivatives contracts are "commodity contracts" under the Bankruptcy Code. Instead, the Commission recommends that the definition of a "commodity contract" be amended to include a "swap that is submitted to a derivatives clearing organization for clearing" by a "swap clearer" (as

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[14] *E.g.*, The Department of the Treasury's "Over-the-Counter Derivatives Markets Act of 2009"; "Principles for OTC Derivatives Legislation", Chairman Barney Frank and Chairman Collin Peterson.

[15] Letter from Gary Gensler, Commission Chairman, to the Chairmen and Ranking Members of the relevant Congressional Committees, dated August 17, 2009, and attached legislative recommendations.

[16] http://www.ny.frb.org/markets/Full_Report.pdf

defined). The broad definition of a "swap" in the Bankruptcy Code would encompass all cleared OTC derivatives contracts.

We welcome the Commission's desire to rationalize the applicable provisions of the Bankruptcy Code and encourage the Commission pursue the adoption of appropriate amendments to the Bankruptcy Code to remove any legal uncertainty surrounding cleared-only OTC derivatives. However, we do not yet understand how these proposed amendments would fit with the existing regulatory regime. For example, the proposed amendments imply that those cleared OTC swaps that currently are subject to a section 4d order could lose that perceived benefit. Further, a "swap clearer" is defined to include a swap dealer, FCM, foreign FCM, leverage transaction merchant, or commodity options dealer that, "directly or indirectly, submits a swap to a derivatives clearing organization for clearing." The proposed amendments imply that an entity other than an FCM could be admitted as a member of a DCO for the purpose of clearing OTC derivatives on behalf of customers. The import of such a result for FCMs and DCOs alike would need to be carefully examined.

We look forward to working with the Commission to better understand its recommendations and, perhaps, suggest further improvements. With the state of the law surrounding cleared OTC derivatives in such flux, especially in the event of a default of an FCM carrying such cleared OTC derivatives, we respectfully suggest it may be appropriate that the Commission defer action on the proposed amendments to the Bankruptcy Rules creating a "cleared OTC derivatives" account class, until Congress has an opportunity to decide how to respond to the various recommendations presented.

Conclusion.

We appreciate the opportunity to submit these comments. If the Commission has any questions concerning the matters discussed in this letter, please contact Tammy Botsford, FIA's Vice President and Assistant General Counsel, at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Gary Gensler, Chairman
Honorable Michael Dunn, Commissioner
Honorable Jill E. Sommers, Commissioner
Honorable Bart Chilton, Commissioner

Division of Clearing and Intermediary Oversight
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EXHIBIT C

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FIA

September 30, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21ST Street NW
Washington DC 20581

Re: The Governance of Self Regulatory Organizations
69 *Fed.Reg.* 32326 (June 9, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA")[1] is pleased to respond to the Commodity Futures Trading Commission's ("Commission") request for comments concerning the governance of self-regulatory organizations ("SROs"), 69 *Fed.Reg.* 32326 (June 9, 2004).[2] This letter expands upon the matters that FIA discussed in the position paper that we forwarded to the Commission on June 8, 2004 ("Position Paper"),[3] a copy of which is enclosed as Exhibit A. Recent developments in the futures markets, such as the demutualization of SROs, competition among organized exchanges and the move to for-profit structures, as well as the development of competing dealer markets for over-the-counter derivatives products, warrant the Commission's careful reexamination of SRO governance. The *Federal Register* release reflects careful thought about all aspects of the efficacy of self-regulation in the futures industry.[4]

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[1] FIA is a principal spokesman for the commodity futures and options industry. Our regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCM") in the United States. Among our approximately 150 associate members are representatives of virtually all other segments of the futures industry, both national and international, including US and international exchanges, banks, legal and accounting firms, introducing brokers, commodity trading advisors, commodity pool operators and other market participants, and information and equipment providers. Reflecting the scope and diversity of our membership, FIA estimates that our members effect more than 80 percent of all customer transactions executed on US contract markets.

[2] 69 *Fed. Reg.* 32326 (June 9, 2004) ("Release"). The Commission extended the comment period to Sept. 30, 2004. 69 FR 42971 (July 19, 2004).

[3] Letter to Honorable James Newsome, Chairman, Commodity Futures Trading Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004.

[4] FIA has had a long-standing interest in SRO governance issues and, in addition to the Position Paper, has submitted several previous comment letters to the Commission on various SRO governance matters. *See, e.g.,* Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004 (Futures Market Self-Regulation); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated July 14, 2003 (Chicago Board of Trade and Chicago Mercantile Exchange Rules); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated August 16, 2000 (A New Regulatory

Introduction

FIA believes that self-regulation, combined with effective oversight by the Commission, is in the public's best interest — by ensuring the most meaningful and effective protections at the lowest cost. Input from the industry can improve the likelihood that SRO rules will achieve their intended goals. Similarly, input from industry participants can help disciplinary panels evaluate questionable behavior with the benefit of knowledge and experience.

However, FIA is concerned that, in light of the recent developments described above, long-standing conflicts of interest existing in the current SRO structure could lead to problems that might jeopardize public confidence in the fairness of our markets.[5] For example, under the current structure, it is possible that SROs could use their regulatory authority for anti-competitive purposes or to adopt rules that benefit parochial interests at the expense of the public interest. We also believe that the Commission should more extensively evaluate certain rulemaking and regulatory processes at the SROs, and can do so without moving to a prescriptive regulatory environment.

We respectfully suggest that the Commission should take measured actions to strengthen its own oversight functions and to enhance the independence and integrity of the self-regulatory structures within SROs. By so doing, the Commission may prevent problems in the future. FIA believes that these suggestions, although significant, may be viewed as evolutionary reforms to the current system.

Recommendations

In order to minimize the potential for abuse arising from actual and perceived conflicts of interest,[6] FIA recommends that the following four goals inform the SRO governance initiative:

Framework for Multilateral Transaction Execution Facilities, Intermediaries, and Clearing Organizations; Exemption for Bilateral Transactions); Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated October 9, 1999 (Petition for Exemption Pursuant to Section 4(c) of the Commodity Exchange Act).

[5] In our comments on the proposed amendments to the Joint Audit Agreement, we noted that "the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement." Letter to Jean A. Webb, Secretary to the Commission, from John M. Damgard, President, Futures Industry Association, dated June 18, 2004, p. 3. A copy of this letter is enclosed at Exhibit B. As there, our comments in this letter are designed to reduce the conflicts of interest that are inherent in any self-regulatory structure.

[6] Section 5(d)(15) of the Commodity Exchange Act ("CEA") as amended by the Commodity Futures Modernization Act of 2000 ("CFMA"), requires that a board of trade "establish and enforce rules to minimize conflicts of interest in the decision making process of the contract market and establish a process for resolving such conflicts of interest." *See also* the Release at Question 14.

- Require board-level independence of SRO oversight accountable directly to the Commission;
- Accentuate the separation of an SRO's business and regulatory functions;
- Increase both the transparency of the regulatory process and industry participation in the regulatory process; and
- Better assure the confidentiality of members' proprietary information to prevent improper use.

We believe that the Commission should use its existing authority under the Commodity Exchange Act ("Act"), and in particular, its authority to ensure compliance with the core principles of Section 5(d) of the Act, to achieve these goals.[7] We also believe that these goals are in the long-term best interests of the SROs. We address each of these goals in greater detail below.

1. Independence of Regulatory Functions

FIA has previously observed that "there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses."[8] The most effective means for strengthening the independence of the regulatory functions is by focusing on SRO governance. In order to strengthen the independence of regulatory functions, the independence of SRO board members, *vis-à-vis* the current composition of SRO boards, should be strengthened.

In the Position Paper, FIA outlines a critical reform necessary to address our concerns about conflicts of interest. Specifically, a "Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities."[9] This reform, along with others outlined in this letter, should minimize the risk that an SRO could use its regulatory authority for inappropriate purposes, or fail to use it in necessary circumstances.

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[7] *See also* Sections 5(d)(1), 5c(d), and 8a of the Act, as well as §1.64, Appendix B to Part 38, §38.5§, and 40.6. Section 5c(a)(1) provides that "the Commission may issue interpretations or approve interpretations submitted to the Commission, of section 5(d) [exempt boards of trade], 5a(d) [core principles for registered derivative transaction execution facility] and 5b(d)(2) (*sic*)[correct statutory reference is section 5b(c)(2)) derivatives clearing organizations] of this title to describe what would constitute an acceptable business practice under such sections." This letter is devoted primarily to governance of SROs that are designated contract markets ("DCMs"). However, in light of these provisions of the Act, FIA believes that its observations should apply with equal force to SROs other than contract markets to the extent that the same issues arise with respect to those SROs.

[8] Position Paper at I.

[9] Position Paper at I.

FIA continues to have concerns about some definitions of "independent director." As FIA observed in the Position Paper, it is not convinced that current exchange and others' definitions of "independent" are adequate to achieve these objectives. Some current standards define "independence" merely as not having a relationship with the SRO as an entity. At a minimum, FIA believes that independent directors should not be currently active in the industry or too recently associated with an SRO member

In addition, the independent board committee should have direct and unfettered access to information to ensure that it is making fully informed decisions. Further, it should have the ability to retain independent outside counsel in appropriate circumstances. Finally, FIA believes that the nomination process for independent directors of SROs should be free of management or member influence. Accordingly the nominating committee for the independent SRO board supervisory committee should be comprised only of independent individuals who meet the requisite independence test for directors.

FIA believes that, consistent with Core Principles 14-16[10], the Commission should use its authority to require SROs to implement the reforms outlined above and to ensure continued compliance. These changes would ensure greater independence of the board generally and the key committee described above to screen out inappropriate appearances of bias or conflicts. As a consequence, the changes would help SROs achieve the goal of greater independence of the regulatory function.[11]

2. Separation of Marketplace and Regulatory Functions

A second aspect of any reform must focus on ensuring an effective separation of an SRO's marketplace and regulatory functions. If an SRO is allowed to "commingle" its marketplace and regulatory functions, both an incentive and a potential exist for the SRO to use its regulatory functions to promote its marketplace or the pecuniary interests of its owners.

To enhance the independence of an SRO's regulatory functions, FIA believes that, at a minimum, functional separation of compliance and business staffs is necessary. Compliance and surveillance staff should report to the independent board committee. Those who manage the business unit of an SRO should not play any role in supervising compliance and surveillance staff. If the SRO contracts out any regulatory function, the independent contractor still should not report to business managers. Any other structure creates conflicts of interest and undermines the recommended separation and the role of the independent board committee.

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[10] The Commission issued an adopting release interpreting the Core Principles. 66 FR 42256 (Aug. 10, 2001). The Commission could consider further interpretations of the Core Principles to ensure that SROs are satisfying Congress's objectives in the CEA, as amended by the CFMA.

[11] FIA also notes that it believes industry members of SRO committees, including boards of directors, should include a broad representation of different constituencies. For example, in certain instances it would not be appropriate for disciplinary committees to exclude certain segments of the futures industry. *See* discussion below.

Consistent with the Position Paper, the committee of independent directors should have responsibility for:

- reviewing regulatory budgets;[12]
- ensuring adequate staff and resources;
- hiring, firing, and compensation of compliance and surveillance staff;
- achieving the requisite degree of separation of compliance and surveillance staff from other SRO staff;
- assessing and reviewing the performance of the self regulatory programs; and
- otherwise overseeing all aspects of the exchange's institutional regulatory functions.

3. Transparency of Regulatory Process/Ability to Participate in Process

A third aspect of any reform must enhance the transparency of the regulatory and disciplinary processes and protect the ability of a broad cross-section of the industry, including FCMs, to participate in these processes. Except where there are overriding concerns of confidentiality, SROs should make their own internal structures and processes transparent to outsiders.

Rulemaking

The rules[13] that an SRO adopts and the manner in which it enforces them are critical to complying with the core principles and, as important, to properly meeting its responsibilities as an SRO. Among other requirements, section 5(b) of the Act, which sets out the criteria for designation as a contract market, imposes on DCMs the obligation to adopt and enforce rules (1) to ensure fair and equitable trading, (2) to ensure the financial integrity of transactions entered into by or through the facilities of the DCM, (3) to prevent market manipulation, and (4) to discipline members or market participants that violate such rules. To both enhance the quality of SRO rulemaking and engender confidence in the SRO rulemaking process generally, the procedures by which a DCM adopts and enforces these rules should be transparent and should assure that members and other market participants, not just one constituency, have an opportunity to express their views and otherwise participate in the process.[14]

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[12] Disciplinary fines should not be taken into account in setting budgets. Fines that are collected should be dedicated solely to enhancing the contract market's regulatory activities or expanding professional and customer education.

[13] For purposes of this comment letter, the term "rule" has the same meaning as set forth in Commission Rule 40.1.

[14] The ability of market participants to have a role in developing the four categories of rules referenced above is particularly important, since they are most directly affected by such rules. In this regard, it generally would not be acceptable if such rules were developed solely by SRO staff and approved by the independent directors of the exchange or independent members of a committee.

Neither the Act not the Commission's rules prescribe the procedures that an SRO should follow in adopting rules. Nonetheless, we believe the essential elements of these procedures are implied in Part 40 of the Commission's rules. In particular, Commission Rules 40.5(a)(1)(v) (voluntary submission of rules for review and approval) and 40.6(a)(3)(iv) (self-certification of rules) each require a DCM to "describe any substantive opposing views expressed with respect to the proposed rule that were not incorporated into the proposed rule."[15] Further, Commission Rule 40.5(a)(1)(iv) requires an SRO, in submitting a rule for approval, to include in its submission, an explanation the operation, purpose and effect of the rule, including, as applicable, a description of the anticipated benefits, any potential anticompetitive effects, and how the rule fits into the framework of self-regulation.[16] We submit that an SRO cannot comply with the provisions of these rules—and the Commission cannot properly determine whether the SRO's rules violate applicable core principles, including the requirement that the SRO endeavor to avoid adopting any rule that results in an unreasonable restraint of trade or imposes any material anticompetitive burden on trading[17]—unless the SRO's rulemaking procedures are designed to solicit input from members and affected market participants on significant rule proposals.

As noted, to date the Commission has offered little direct guidance to DCMs in meeting this responsibility. We are not yet prepared to state that formal guidance pursuant to section 5c(a) of the Act is necessary. As an initial step, the Commission should request each SRO to submit for the Commission's review the written procedures by which the SRO develops and adopts rules. Only following this review should the Commission consider whether it would be appropriate to provide guidance to SROs in this area. The Commission's Part 40 rules could provide the foundation for the Commission's review and any guidance it may subsequently elect to issue.

We recognize that the Commission's rule review procedures are not the subject of this request for comment.[18] Nonetheless, the procedures by which an SRO adopts its rules and the procedures by which the Commission reviews such rules are inextricably linked.

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15 Rule 40.5(a)(1)(v); Rule 40.6(a)(3)(iv) is similar.

16 Although an SRO is not required to include such a written explanation in self-certifying a rule pursuant to Rule 40.6, we fail to see how an SRO could certify that the rule complies with the Act and the Commission's regulations unless it prepared such a document for its own files and for consideration by the board or appropriate committee prior to the adoption of the rule. Further, the board's committee of independent directors, recommended above, should have the responsibility to make any such certification, whether mandatory or voluntary.

17 Section 5(d)(18) of the Act.

18 However, then-Chairman James Newsome noted his view that review of Commission procedures and SRO procedures should occur together. "In this regard, just as I think it's important for the Commission to review our own regulatory structure, I also believe it's equally necessary for SROs, in consultation with us, to do the same." Address by Chairman James E. Newsome of the U.S. Commodity Futures Trading Commission at the Futures Industry Association Law and Compliance Luncheon Chicago - May 28, 2003, http://www.cftc.gov/opa/speeches03/opanewsm-40.htm

In addition, to the extent that affected market participants are not afforded an opportunity to have their views taken into account when an SRO adopts rules, FIA believes they must have the opportunity to seek redress with the Commission. Transparency in the Commission's consideration of SRO rules and the opportunity for public participation in this process is no less important than in an SRO's adoption of such rules. In appropriate circumstances, a request for comment should be published in the *Federal Register* as well as on the Commission's website, and the public should be afforded a reasonable amount of time to analyze the rules and prepare comments. The Commission's decision with respect to such rule, including its analysis of the comments, received should also be made available to the public.[19] FIA urges the Commission to implement the changes described with respect to both the processes at the SROs and its own oversight function.

Disciplinary Process

Conflicts of interest and other problems can impair the fairness and efficacy of the current SRO disciplinary process. FIA notes that narrowly drawn industry participants currently dominate many hearing panels. Consequently, peers judge peers and competitors judge other competitors. In addition, when one class of market participant dominates a disciplinary panel, other classes of market participants subject to the panel's disciplinary review may perceive the process to be unfair.

For these reasons, FIA recommends several reforms to the disciplinary process. Perhaps most importantly, neither the industry as a whole nor a particular industry segment should dominate disciplinary panels. However, it is important to recognize that industry participants can play a valuable role on a more balanced panel, particularly when the industry participant does not represent an industry segment that competes against the segment employing the person or entity charged. Industry participants can provide a "reality check" and industry knowledge to

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[19] An example of the importance of such procedures is the Commission's consideration of the Chicago Board of Trade and the Chicago Mercantile Exchange rules implementing the clearing link between these two exchanges. The exchanges submitted these rules pursuant to Commission Rule 40.5. Despite the fact that these rules significantly affected the rights and obligations of Chicago Board Trade clearing members and their customers, they were developed and adopted with little or no input from affected members. Yet, the Commission afforded market participants only three business days to analyze and prepare comments on the rules. As troubling, the Commission allowed itself less than one day to consider the comments that were filed before voting to approve the rules. Notwithstanding comments that raised what many considered significant questions of law, the Commission did not publicly address these questions in approving these rules.

Another example is the New York Mercantile Exchange's ("Nymex's") proposed amendments to rule 9.23, Protection of Clearing House. As the Commission is aware, as initially approved by the exchange, this rule would have significantly altered the purpose of the clearing house guarantee by authorizing the use of the Guaranty Fund and other Clearing House assets in certain instances to make whole the non-defaulting customers of a defaulting clearing member. The Nymex board approved this rule without adequate consultation with all affected clearing members of the exchange. After learning of the amendments, the members were able to convince the board to withdraw the rule amendments before they were submitted to the Commission. However, if the amendments had been submitted to the Commission, there would have been no apparent procedures by which affected market participants could have requested Commission review.

independent panelists. Furthermore, including panelists from the same industry segment as the person or entity charged can help guard against the possibility that panel members may not know enough about the behavior to judge it properly or worse, may want to punish a competitor from an alternative market.

However, FIA recognizes that including people from the same industry segment creates the risk that a panel may impose sanctions that are too light — protecting a friend; hoping that the competitor will remember the favor if roles are reversed in the future — or conversely, may impose sanctions that are too harsh — punishing a direct competitor. To address these concerns, FIA recommends the following reforms: (i) the independent committee of the board should appoint disciplinary panels; (ii) as noted in the Position Paper[20], disciplinary panels should be made up of a majority of knowledgeable independent panelists; (iii) industry members who represent a fair cross section of the industry should augment the panels[21]; (iv) at the request of non-industry panelists, the disciplinary panel should be able to seek the views of independent experts; and (v) aggrieved persons or entities should have the right to appeal to the full committee of independent directors or to a panel comprised solely of such independent committee members.

4. Preventing Unauthorized Disclosure of Confidential Information

A fourth aspect of any reform must focus on ensuring the confidentiality of information. The absence of confidentiality protections compromises other goals outlined above: independence of the regulatory function; separation of marketplace and regulatory functions; and transparency of/participation in the regulatory process.

Currently, SRO committees and in some cases the entire board of directors review disciplinary records and settlements, which may reveal confidential information. Industry personnel should not be able to use for commercial advantage information about a competitor that they obtained as a result of their service on an SRO committee or board of directors. Similarly, marketing and business staffs should never be permitted to use information obtained in their regulatory or compliance functions for business purposes. To limit the number of people who become privy to confidential proprietary information, therefore, FIA recommends that SROs modify their processes to ensure that only independent board members, relevant committees, such as business conduct and financial compliance, if applicable, and regulatory staff have access to such information.[22] The more people who know confidential information, the less the likelihood is that the information will remain confidential.[23]

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[20] Position Paper at II.

[21] *See* discussion below concerning confidentiality of information.

[22] As discussed above, we also recommend that the business and marketing staffs of an SRO be functionally separate from the regulatory and compliance staffs.

[23] In our June 18, 2004 letter to the Commission on the proposed revisions to the Joint Audit Agreement, we noted that the Commission had "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-

FIA recognizes that SROs have generally adopted codes of conduct, which include a provision prohibiting any person involved in the SRO process from disclosing or taking commercial advantage of confidential proprietary information obtained in the course of SRO activities. All such codes should be transparent and publicly available. Further, SROs should require their board members, staff, and outside consultants to sign such codes before undertaking SRO responsibilities.[24]

Conclusion

FIA appreciates this opportunity to comment on SRO governance. If the Commission has any questions concerning the comments in this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable Sharon Brown-Hruska, Acting Chairman
Honorable Walter L. Lukken, Commissioner

Division of Market Oversight
Richard A. Shilts, Acting Director
Steven B. Braverman, Deputy Director
Rachel Berdansky, Special Counsel

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regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures." FIA endorsed the Commission's request and urged the Commission to make any information submitted by the SROs publicly available. To date, neither the SROs nor the Commission has released any information in this regard.

[24] The Position Paper recommends that "the FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions." The Position Paper explains that "given the number of exchanges that have SRO and DSRO responsibility, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges." Position Paper at IV. We suggest that the development and review of codes of conduct for confidentiality and other purposes could be the first such project.

EXHIBIT A

CFTC Study of Self-Regulation
Position Paper of the FIA
June 8, 2004

Summary

FIA supports the important role that exchanges and clearing houses perform as self-regulatory organizations (SRO) and designated self-regulatory organizations (DSRO). Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure.

FIA believes there is merit in the existing structure worth preserving and that more extreme alternatives are not desirable and are less efficient. Nevertheless, the existing structure can be improved through greater transparency and oversight that will minimize any potential conflict of interests. To be fully effective, there must be an increased degree of confidence in the integrity and objectivity of the SRO. We believe that specific modifications to the SRO structure can increase its overall efficiency and effectiveness. In addition, a clear delineation of the role and responsibility of the CFTC in proactively overseeing these SRO functions will enhance SRO performance and public confidence in the SRO structure.

The CFTC has been progressing with its review of the effectiveness of self-regulation in the futures industry. To facilitate this review, FIA has prepared this Position Paper to highlight key areas of concern in the hope that the CFTC will recognize the merits of these positions and take them into account in its assessment and recommendations for change in SRO responsibilities. In this regard, there are four broad issues that FIA recommends the CFTC address in its SRO Study. For each of these issues, FIA provides recommendations for specific changes to current SRO structures.

I. Potential Conflict of Interests - There should be a division between the business and SRO/DSRO functions of exchanges and clearing houses.

The exchanges provide a public good and public service through price discovery and a well-defined marketplace yet there is both the perception and some indications of actual conflicts of interest between the business side and the SRO functions of exchanges and clearing houses. This problem potentially is exacerbated by demutualization and the move to for-profit structures. FIA recognizes that shareholders of for-profit structures are motivated in the long run to ensure market integrity and their failure to do so should ultimately reduce revenues and profit; however, there may be times when specific events will override the longer-term objectives of the exchange.

Recent legislative and regulatory actions against public companies, including the enactment of the Sarbanes-Oxley Act, suggests that without specific safeguards for-profit companies may not always act in the public interest. The possibility that exchanges or clearing houses can abuse

their SRO responsibilities to the detriment of market participants and the public good cannot be dismissed. FIA believes that a more formal separation between the business and SRO functions of exchanges and clearing houses is essential to overall marketplace integrity. In that regard, we have the following recommendations.

- **A Committee of the exchange/clearing house Board of Directors made up of independent, non-industry directors should be responsible for SRO/DSRO activities and responsibilities.**

FIA recommends that each exchange/clearing house have such a Board Committee of independent, non-industry directors and that the Committee have the responsibility to oversee the SRO/DSRO budget, hire and fire compliance staff, ensure adequate staff and resources, review cases, audit SRO/DSRO performance and otherwise oversee all aspects of the SRO/DSRO function. In addition, it is absolutely critical that there be a definition of "Independent" that avoids any appearance of bias, conflict or any lack of independence. FIA is not convinced that current exchange and others' definitions of "independent" are adequate in these regards. In addition to being independent, these directors should not be currently active in the industry.

- **The Board Committee should be responsible to the CFTC for its oversight of the SRO/DSRO functions**

Like independent audit committees of public company boards under Sarbanes-Oxley, this Board Committee should have real accountability. Its activities, its responsibility for the budget and the audit all should be reviewed by the CFTC at least annually.

- **There should be a more formal separation between the business and compliance/surveillance staffs of exchanges and clearing houses.**

Compliance and surveillance staff should report to the Board Committee. They should not be involved in the business activities of the exchange or clearing houses and should not be in a supervisory chain that includes managers on the business side of the exchange or clearinghouse. To the extent the SRO function is contracted out, it still should not report to business managers. Any other result creates conflicts of interest and undermines the recommended separation and the role of the independent Board Committee.

II. **Appearance of Bias – A majority of the members judging proceedings should be disinterested parties.**

FIA recognizes that its concerns about SRO fairness will be reduced with the adoption of its recommendation of Board Committees of independent, non-industry directors overseeing SRO/DSRO functions. However, additional measures must be taken to address related issues of fairness and confidentiality and to ensure SRO decision-makers will be independent of business pressures. In particular FIA is concerned that disciplinary panels dominated by peers judging peers has an inherent appearance of bias. Equally, disciplinary panels consisting of only one category of market participant can be seen as unfair especially from the viewpoint of other categories of market participants subject to the panels' disciplinary review. Market participants are entitled to a fair hearing. In this regard, FIA has the following recommendations.

- **A majority of the members of disciplinary panels should be made up of knowledgeable independent panelists.**

While FIA respects the experience and judgment of interested panel members, an appearance of fairness and the avoidance of bias are enhanced when a majority of disciplinary panel members are independent. Consideration should be given to permitting parties subject to discipline to request panels made up entirely of independent members.

- **Interested parties should not review the records of disciplinary proceedings and settlements.**

Currently, exchange committees and in some cases the entire Board of Directors reviews disciplinary records and settlements. These records reveal confidential information that should not be shared with competitors or other interested parties. The use of independent committees and the Board Committee of independent directors should address this problem.

III. **Enhanced Transparency – The CFTC should establish clear standards for DSROs and the allocation of firms among them.**

The efficiencies of the DSRO approach are widely recognized. At the same time, providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function. The CFTC should establish clear standards for qualification as a DSRO including a process to approve new providers wishing to perform financial compliance audits. Each of these providers should be subject to periodic CFTC review of their DSRO functions. This oversight should include detailed review of DSRO audits. A mechanism should be established to make the choice of DSRO cost neutral to exchange members. Subject to CFTC adopted standards, a member firm should be able to change its DSRO within the narrow band of CFTC pre-approved providers.

IV. **Sound Practices – The FIA along with other futures organizations and exchanges should establish sound practices for SRO/DSRO functions.**

Given the number of exchanges that have SRO and DSRO responsibilities, FIA believes there should be an established set of SRO/DSRO sound practices applicable across all of these exchanges. These sound practices should follow the model of core principles in the Commodity Futures Modernization Act. In particular, directors who serve on the independent Board Committee with oversight responsibilities over SRO and DSRO activities should be trained to apply these industry-wide sound practices.

Conclusion

FIA believes that this is an ideal opportunity to improve a process that has largely been successful but may have certain conflicts and biases. FIA's hope in raising these issues and making these recommendations is to promote a dialogue that will lead to a fairer and more efficient SRO structure for the futures industry.

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EXHIBIT B

June 18, 2004

Ms. Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20581

Re: Futures Market Self-Regulation, 69 *Fed.Reg.* 19166 (April 12, 2004)

Dear Ms. Webb:

The Futures Industry Association ("FIA") is pleased to submit this letter in response to the Commodity Futures Trading Commission's ("Commission's") request for comments on the proposed revisions to the Joint Audit Agreement to be entered into among the several self-regulatory organizations ("Proposed Agreement").[25] FIA supports the important role that exchanges and the National Futures Association ("NFA") perform as self-regulatory organizations ("SROs") and designated self-regulatory organizations ("DSROs").[26] Given their strong market knowledge and close proximity to the trading markets, they provide the best forum for addressing many of the futures markets' oversight functions. However, as explained in detail below, we are concerned about potential conflicts of interest and the appearance of unfairness in the existing structure that would be ratified in the Proposed Agreement.

Before addressing specific aspects of the Proposed Agreement, however, FIA notes that the Commission recently issued a *Federal Register* release requesting comment on a series of questions relating to the structure and governance of self-regulatory organizations. 69 *Fed.Reg.* 32326 (June 9, 2004). The latter release, which was issued in connection with the Commission's review of SROs, requests comment on such matters as the composition of boards of directors, issues arising from different forms of ownership, regulatory structure,

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[25] FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 40 of the largest futures commission merchants ("FCMs") in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets.

[26] Pursuant to Commission rule 1.3(ee), an SRO is defined as a designated contract market or a registered futures association. A DSRO is defined under Commission rule 1.3(ff) as an SRO assigned responsibility for monitoring and auditing an FCM in accordance with a plan approved under Commission rule 1.52. Significantly, designated clearing organizations are not self-regulatory organizations under the Commission's rules.

including the structure of disciplinary committees, and potential conflicts of interest generally. FIA recently filed with the Commission a position paper outlining several broad areas of concern in this area and will be preparing a more detailed response to this release.[27]

In our view, the Commission's review of the Proposed Agreement cannot be considered separately from the Commission's more general review of SROs. Certainly, FIA's comments below might well change depending on the Commission's response to our broader concerns. Therefore, we recommend that the Commission defer any decision with respect to the Proposed Agreement until its SRO study is complete.

A Changed Industry

The derivatives industry has undergone significant change in the twenty years since the original Joint Audit Agreement was entered into in 1984 and, in particular, in the years following enactment of the Commodity Futures Modernization Act of 2000 ("CFMA"). Legal uncertainty surrounding over-the-counter ("OTC") derivatives transactions among qualified eligible participants has been resolved, and a burgeoning OTC market in swaps and other derivatives instruments both competes with and complements the exchange traded markets.[28] Many FIA member firms, either directly or through affiliates, are active participants in the OTC derivatives markets. Concurrently, the clearing divisions of the Chicago Mercantile Exchange ("CME") and the New York Mercantile Exchange ("Nymex") both offer to provide clearing facilities for OTC derivatives.

Moreover, exchanges have entered into direct competition with each other. BrokerTec Futures Exchange and, more recently, the U.S. Futures Exchange ("USFE"), an indirect subsidiary of Eurex Frankfurt AG, have challenged the Chicago Board of Trade's ("CBT's") dominance in futures on US Treasury instruments, leading the CBT to counter by offering futures on the German Bund, Bobl and Schatz.[29] Meanwhile, Euronext.Liffe recently began offering futures on Eurodollars, in direct competition with the CME.

Finally, not all clearing organizations are as tied to futures exchanges as they once were. The CBT has terminated its relationship with The Clearing Corporation and has been clearing transactions through the CME since late 2003.[30] The Clearing Corporation now provides

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[27] Letter to James Newsome, Chairman, from John M. Damgard, President, FIA, dated June 8, 2004.

[28] The International Swaps and Derivatives Association ("ISDA") estimates that, as of December 31, 2003: (1) the notional principal outstanding volume of interest rate derivatives, which include interest rate swaps and options and cross-currency swaps, was $142.31 trillion; (2) the notional value of outstanding credit derivatives, including credit default swaps, baskets and portfolio transactions was $3.58 trillion; and the outstanding notional value of equity derivatives, consisting of equity swaps, options, and forwards, was $3.44 trillion.

[29] As a result of its purchase of BrokerTec Futures Exchange, several of the larger FCMs own a significant interest in USFE.

[30] The Clearing Corporation, of course, has always been an independent legal entity.

clearing services for USFE and other exchanges. In addition, the London Clearing House has been approved as a designated clearing organization ("DCO"), but does not yet provide clearing services for any designated contract market ("DCM"). Although not represented on the Joint Audit Committee ("JAC"), independent clearing organizations have a clear and undeniable interest in the financial integrity of member FCMs.[31]

As the above summary indicates, the derivatives industry is anything but static. More important, the exchange and brokerage communities now often appear to be competing for the same business. Consequently, the Commission, the several self-regulatory organizations and the derivatives industry generally must be more sensitive to the appearance of potential conflicts of interest, if not actual conflicts of interest, that may arise from implementation of the Proposed Agreement. Further, we submit that the Proposed Agreement should provide the flexibility necessary to accommodate the inevitable changes the industry will experience in the years ahead.

Voting Eligibility

Paragraph 3 of the Proposed Agreement provides that "[o]nly those Parties which were members of the JAC prior to the year 2000 or which conduct their own auditing activities as a DSRO (rather than subcontracting such responsibilities) shall be eligible to vote." Neither the Proposed Agreement nor the *Federal Register* release requesting comment explains the reasons underlying this provision. On its face, it appears to have no rational basis.

What regulatory purpose is served by granting voting privileges to AMEX Commodities Exchange and the Philadelphia Board of Trade, neither of which currently list products for trading, while denying voting privileges to USFE? Certainly, the distinction cannot be based on the decision of USFE to subcontract certain of its self-regulatory responsibilities to NFA. A review of the Commission's *Selected FCM Financial Data* as of May 31, 2004, indicates that, with a few exceptions, DSRO responsibilities are performed by only three self-regulatory organizations—CBT, CME and NFA.[32] Without further explanation, the provisions of paragraph 3 relating to voting eligibility appear to have no purpose but to assure the continued dominance of the "old exchanges" over the "new exchanges."

Under the Commodity Exchange Act ("Act"), all DCMs have self-regulatory obligations that they are required to meet. Further, although the Act clearly contemplates that DCMs may

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[31] As noted in footnote 2 above, DCOs are not self-regulatory organizations under the Commission's rules. Nonetheless, DCOs have an obvious interest in the financial integrity of their member FCMs. Therefore, procedures should be developed to assure that DSROs provide independent DCOs the same access to financial and other relevant information obtained by a DSRO with respect to a member FCM as the DSRO now makes available to DCOs that are divisions of a DCM. In addition, consideration should be given to inviting independent clearing organizations to participate, if not vote, in meetings of the JAC.

[32] Of the 178 registered FCMs: NFA is the DSRO for 97 FCMs; the CBT is the DSRO for 40 FCMs; the CME is the DSRO for 29 FCMs; Nymex is the DSRO for 10 FCMs; and the Kansas City Board of Trade and New York Board of Trade are the DSRO for one FCM each.

delegate these obligations to a registered futures association, such as NFA, or another registered entity, the Act also provides that that DCM "shall remain responsible for carrying out" these obligations.[33] As long as a DCM has statutory self-regulatory obligations that it is required to meet and, consequently, may be held responsible for the manner in which a DSRO performs these obligations on its behalf, FIA believes that each DCM should have an equal voice in matters that become before the JAC.[34]

Allocation of Firms Among DSROs

As noted earlier, the CBT, CME and NFA serve as the DSROs for essentially all registered FCMs. Further, either the CBT or the CME is the DSRO for all but two of the twenty largest FCMs by amount of segregated funds held.[35] FIA is not concerned that these three entities perform the majority of DSRO activities on behalf of other DCMs. To the contrary, particularly in the area of financial audits, we believe that the expertise demanded of audit staff effectively requires that these responsibilities be exercised by a small number of qualified SROs. Nonetheless, two aspects of the Proposed Agreement cause concern.

First, the Proposed Agreement provides no means by which an FCM may participate in the selection of its DSRO. In addition, once assigned to a DSRO, an FCM may not be reassigned, except with the consent of that DSRO. As we discussed at the outset of this letter, exchanges and their FCM members are increasingly engaged in activities that appear to compete with each other. Consequently, an FCM may find that its activities are being audited by an exchange that is, or at least appears to be, its competitor. In these circumstances, and in order to avoid even an appearance of a conflict of interest, an FCM should have the ability to change its DSRO.[36]

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[33] Section 5c(b) of the Act.

[34] Paragraph 3 of the Proposed Agreement also provides:

> If two or more Parties become commonly owned through a merger or acquisition, the surviving Party is entitled to one representative on the JAC; provided, however, that any Party which maintains a separate legal entity after an acquisition, will retain their representative on the JAC.

FIA agrees that, if two or more DCMs become commonly owned, they should be entitled only to one representative and one vote on the JAC in all instances. The fact that a DCM is maintained as a separate legal entity following an acquisition should not entitle that entity to representation or a vote.

[35] Based on the Commission's *Selected FCM Financial Data* as of May 31, 2004, these twenty firms hold in excess of 85 percent of all customer segregated funds. Of these firms, the CBT is the DSRO for 12, the CME is the DSRO for six and Nymex is the DSRO for two.

[36] We want to be clear that we are not asserting that any DSRO has acted, or would act, in a way that would constitute a conflict of interest. Nor would we anticipate any rush by FCMs to change their DSRO. To the contrary, in our discussions with FIA member firms, they are by and large satisfied with the DSRO to which they have been assigned. Nonetheless, as we noted in our June 8, 2004 position paper on self-regulation, "providing the largest exchanges with effectively exclusive, permanent oversight responsibility has the potential to influence behavior and undermine the independence of the DSRO function."

We have considered various means by which an FCM could be permitted to change its DSRO and suggest that an FCM should be able to change its DSRO on a periodic basis, *e.g.*, every five years.[37] The FCM could request this change for any or no reason. Although an FCM could participate in the selection of its DSRO, the FCM would not have the unilateral right to choose the DSRO that would assume responsibility for the firm. Rather, the DSRO would be chosen from among those SROs that the Commission has determined meets clear and objective standards. Any procedure should assure and prevent any appearance that the FCM was engaging in regulatory arbitrage among DSROs.[38] Separately, FIA believes the Commission should establish procedures in rule 1.52 by which an FCM may petition the Commission to request a change in the FCM's DSRO in the unlikely event that the DSRO has engaged in egregious misconduct conduct with respect to the FCM.

Second, we believe that the exchanges should not have the unquestioned right of first refusal with respect to the allocation of DSRO responsibilities among exchange member firms. As discussed above, in light of the potential appearance of conflict of interests between an FCM and its DSRO, FIA believes that procedures should be considered to permit NFA or another non-exchange entity to serve as an FCM's DSRO, *provided* that entity meets Commission approved standards.

Confidentiality

The information that DSROs obtain in the course of their examinations of member firms and the records they prepare obviously contain confidential proprietary and business information that an FCM would not otherwise disclose. FIA is concerned that the confidentiality provisions set forth in paragraph 8 of the Proposed Agreement do not provide sufficient assurance that such information will not be shared with other divisions of the DSRO or with other SROs except for appropriate cause. Since FCMs are not parties to the Proposed Agreement and otherwise appear to have no cause of action against an SRO that may improperly disclose confidential information, it is particularly important that the responsibilities of SROs in this regard be clearly circumscribed.[39]

In a press release dated February 6, 2004, the Commission announced that it has "encourage[d] every SRO to reexamine its policies and procedures, employee training efforts, and its day-to-day practices to confirm that there are adequate safeguards in place to prevent the inappropriate use of confidential information obtained by SROs during audits, investigations, or other self-regulatory activities." The Commission also encouraged SROs "to publicize these safeguards so that market participants continue to have full faith in the integrity of the self-

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[37] No FCM, however, would be required to change its DSRO under this procedure.

[38] As noted in our June 8 position paper, FIA believes that a mechanism should be established to make the choice of DSRO cost neutral to exchange members.

[39] Again, FIA is not asserting that the audit staffs of any exchange or other SRO have inappropriately shared otherwise confidential business information.

regulatory process and participate enthusiastically in it, even as major changes in the futures markets create new competitive pressures."[40]

Consistent with the Commission's recommendations, FIA respectfully submits that the Proposed Agreement governing confidentiality of FCM proprietary and business information should be revised to describe specifically the limitations on the use of such information. In addition, FIA believes the Commission should consider adopting a rule requiring the confidential treatment of all proprietary and confidential information collected during an examination. Such a rule would assure that violations of FCM confidentiality would be subject to appropriate penalty.

Commission Review

In light of the constant change that is the hallmark of the derivatives industry and the potential conflicts of interest that are inherent in any self-regulatory structure, FIA encourages the Commission to play a more active role in overseeing the activities of the Joint Audit Committee.

Conclusion

FIA appreciates the opportunity to submit these comments on the Proposed Agreement. If you have any questions concerning this letter, please contact Barbara Wierzynski, FIA's General Counsel, or me at (202) 466-5460.

Sincerely,

John M. Damgard
President

cc: Honorable James E. Newsome, Chairman
Honorable Walter L. Lukken, Commissioner
Honorable Sharon Brown-Hruska, Commissioner

Division of Clearing and Intermediary Oversight
James L. Carley, Director
Thomas J. Smith, Associate Director

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[40] FIA supports the Commission's request that SROs examine their policies and procedures designed to protect the confidentiality of member information and make these policies and procedures public. FIA is not aware that any SRO has responded to the Commission to date. We recommend that this information be made publicly available as soon as possible in order to afford FIA and others an opportunity to submit comments in response to the Commission's June 9, 2004 *Federal Register* release.